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January 14, 2002

BY HAND DELIVERY
Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, MA 02110

Re: Risk-Management Techniques, D.T.E. 01-100

Dear Ms. Cottrell:

Enclosed for filing please find an original and fifteen (15) copies of the Response of Fitchburg Gas and Electric Light Company ("FG&E") to the Department of Telecommunications and Energy's ("Department's") Notice of Inquiry in the above-referenced proceeding. As required by the Department's Notice, I have also enclosed a disk of FG&E's comments for electronic filing.

Thank you for your continuing assistance.

Very truly yours,

Patricia M. French

PMF/rtm

Enclosures

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

RISK MANAGEMENT TECHNIQUES FOR)
LOCAL GAS DISTRIBUTION COMPANIES) D.T.E. 01-100

RESPONSE OF FITCHBURG GAS AND ELECTRIC LIGHT COMPANY TO NOTICE OF INQUIRY

On December 4, 2001, the Department of Telecommunications and Energy ("D.T.E." or "Department") opened an investigation to explore the appropriateness of the use of risk-management techniques to mitigate natural gas price volatility. The Department inquired whether various risk-management tools that may mitigate volatility of natural gas commodity costs may be used in the Commonwealth, and whether such use by local distribution companies ("LDCs") would be in the public interest.

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Executive Summary

FG&E believes that the Department should permit LDCs to engage in risk management in order to mitigate price volatility for ratepayers. Such techniques would permit LDCs to match more closely the price established in its CGA, depending upon the portion of the portfolio to which risk management tools are applied, and reduce reliance on the CGA's "true-up" mechanism. The volume of load hedged should reflect a level up to expected net firm loads, and no more.

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Risk management tools should be expected to reduce the need for mid-course corrections in the CGA and should add to the steps already taken by the Department to reduce gas price volatility by prescribing when these mid-course corrections should be filed by LDCs. It should be recognized that price predictability is *the* key objective of any risk management program, and not reduced gas costs. There is no guarantee that the application of risk management tools will reduce gas costs but rather the tool should be looked at as an "insurance policy" to guard against significant increases or spikes in these costs. As with any insurance policy, this price predictability comes with a cost. The cost of the contract itself, while nominal, is incremental to the relatively large cost of the physical gas supply.

Finally, the Department should review an LDCs attempt at managing risk through these techniques based on what the LDC reasonably understood the market to be at the time it entered into the risk management contract. The CGA permits full recovery of an LDCs commodity cost, and is counterbalanced appropriately by the Department's historic least-cost policies. Under the Department's current regulations, the CGA operates as a cost recovery mechanism, without either significant risks to recovery or benefit of profit to the LDC. Because the CGA is oriented toward cost recovery, the justification for Department authorization of an incentive mechanism related to gas supply costs is reduces.

D.T.E. Question No. 1: Should Massachusetts gas utilities be allowed or required to implement a risk-management program to mitigate price volatility for gas customers?

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FG&E Response: Massachusetts LDCs should be allowed, but not required, to use basic risk-management techniques to mitigate price volatility and to recover any reasonable and prudent incremental cost associated with employing risk-management techniques.

D.T.E. Question No. 2. How will risk management by LDCs affect gas unbundling and customer choice in Massachusetts?

FG&E Response: An LDCs gas price is one of the major drivers that benchmarks what competitive suppliers must beat to offer better prices to retail customers. Currently the CGA price "benchmark" uses LDC estimates of what gas cost will be, but the actual cost may be different due to load driven by weather factors and changes in market gas prices for any gas supplies that the LDCs have not yet locked in. By either purchasing physical gas at fixed prices or using gas futures or futures options, LDCs would be able to eliminate much of the market price change after the CGA is filed. The actual CGA reconciliation would still be subject to the weather and load migration effects, but the "after-the-fact" reconciliation impact on the CGA would be reduced, and therefore the CGA would become a more reliable price signal for both marketers and customers that are contemplating retail choice.

D.T.E. Question No. 3. Should gas utilities be limited to specific types of risk-management instruments? If so, what types?

FG&E Response: LDCs should at least be able to use natural gas futures to meet the expected warm winter load requirements, net of expected retail choice load. They should be able

to use futures options contracts for the volumes required to meet design cold winter needs, net of expected retail choice load. Other hedging instruments could also be used, but the volume related to the hedge instruments should be reflective of the expected net firm loads of the LDCs. In FG&E's opinion, volumes significantly above that reflect speculation on market movements and would be inconsistent with an LDCs obligations, under the Department's present regulations.

D.T.E. Question No. 4. Should there be a percentage volume of gas that LDCs would be allowed to hedge?

FG&E Response: The limit to hedging should not be based on a percentage volume. As discussed in FG&E's Response to Department Question No. 3, above, in FG&E's view, the volumes subject to hedging should be related to the LDC's expected load, net of migration to retail suppliers. Firm obligations to take (or pay for) gas, such as futures contracts, should be limited to the minimum volumes the LDC expects to serve under design warm conditions. Option volumes could be used, up to the expected loads for design cold weather. The "expected" LDC load is subject not only to the traditional growth and weather risks, but also to migration to choice. As part of CGA filings, the Department may find it useful for LDCs to explain their migration assumptions and resulting expected loads, thus identifying for the Department the "net volumes" potentially subject to risk-management instruments in advance.

Critically, the Department should recognize that even a careful and prudent analysis of expected net loads to determine a percentage of load to hedge may be insufficient to ensure an upside result. For example, while the CGA may be set with the benefit of the best

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form of risk management, if the spot price of natural gas were drop surreptitiously after the CGA were set, load would follow the market. Fortunately, because the Department now mandates that LDCs refile a CGA when events demonstrate that a 5% over- or under-collection is likely, any such price distortion would be most likely short-lived. But in such an unanticipated situation, the effect of placing a full expected net load to any form of risk management that protects against upside risk is obvious.

D.T.E. Question No. 5: What should the core objectives of a hedging program be (e.g. least cost, price stability)?

FG&E Response: Price predictability is the primary goal of any LDC hedging program. Arguably, in the long run, the least-cost strategy is to buy spot gas to fill the required pipeline transport and be assured of meeting design warm and cold scenarios. Hedging is an insurance product and understandably comes at an additional cost. Its value is improved price predictability. At times, hedging will result in total costs below a purely spot price supply. At other times it will limit or even prevent recognition of spot price drops. The fundamental point is that the price stability that results from the consistent use of risk-management techniques is a valuable product that retail suppliers should be offering their retail customers. If the LDC hedges its load, then -- to a degree -- it does so in competition with competitive suppliers, driving retail suppliers to compete with the raised bar of price and service performance.

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D.T.E. Question No. 6: How will the Department assess risk-management programs? What benchmarks should be used to measure a risk-management program's performance?

FG&E Response: The Department's assessment of risk-management programs should be consistent with its review of the LDCs expected loads, net of migration as presented in the LDCs CGA filing(s). In FG&E's view, such an assessment should recognize that there could be significant movement in prices between the time the LDC files the CGA and the Department approves the CGA, and between the Department's approval and the time the LDC implements any of the risk-management instruments. Thus, the end result could be somewhat better, or perhaps not as good as, the filed CGA rate. Price changes are not known in advance; perfect hindsight is a most inappropriate standard to be applied to a risk-management program. In accordance with sound regulatory policy, decisions regarding the application of risk-management tools must be reviewed based on the information available at the time the decisions were made, not based on what becomes known subsequently. Furthermore, any strategy of market timing is a form of speculation. Speculation should not form a part of any LDC's risk-management program.

D.T.E. Question No. 7: What standard of review should the Department apply to the utilities' initial risk-management program?

FG&E Response: The Department's standard of review should not be one of perfection, but one of reasonableness, without the benefit of pricing and volume hindsight. Hindsight gives perfect knowledge both to pricing and to volume risk, which factors can be driven by weather, by

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migration to retail suppliers or by general economic climate. In addition, the Department's standard of review should acknowledge that both companies and ratepayers accept and employ risk-management techniques precisely because future prices are unknown. In particular, options are used effectively to cover the volume risks. Risk management techniques can in fact reduce risk, but are not designed to be part of any long-term least cost process.

D.T.E. Question No. 8: What types of costs are associated with risk-management? Should LDCs be allowed to recover these costs? If so, please explain how.

FG&E Response: The primary incremental costs are the transaction fees associated with obtaining the risk-management contracts. In FG&E's view, the incremental transaction costs incurred to implement a hedging program should be included and recoverable in the LDCs CGA. If this cost were not subject to recovery, the LDC would be providing a service at no cost that a competitive retail supplier would provide on an "included cost" basis. The competitive retail supplier, therefore, would price gas with additional costs not borne by the LDCs ratepayers under the LDCs gas commodity cost. This differential may act either as a price disincentive for retail customers to chose competitive natural gas supply, or alternatively, as a disincentive for LDCs to implement risk-management instruments.

D.T.E. Question No. 9: Should an incentive mechanism be used in conjunction with a risk-management program? If so, please explain how this mechanism should be structured.

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FG&E Response: Under the Department's current regulations, the CGA operates as a cost recovery mechanism, without either significant risks to recovery or benefit of profit to the LDC. Because the CGA is oriented toward cost recovery, the justification for Department authorization of an incentive mechanism is reduced.

Respectfully submitted,

FITCHBURG GAS &ELECTRIC LIGHT COMPANY

By Its Attorneys,

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